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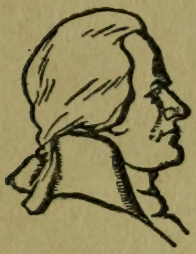
[Modern business Talks]

BASING DECISIONS ON THE FACTS

Adequate accounting records, accurately kept and intelligently judged, form the basis for business policies.



MODERN BUSINESS
Talk No. 43
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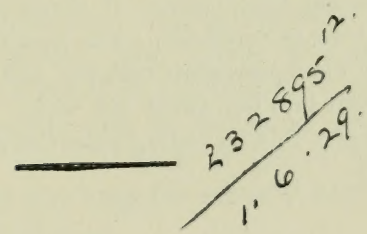
Basing Decisions on the Facts

This Talk, to be read in connection with Volume 22, forms part of READING ASSIGNMENT 44



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READING ASSIGNMENT

The current Reading Assignment consists of three parts: (1) this Talk; (2) Chapters I to X of Volume 22, "Financial and Business Statements," and (3) Lecture No. 22.

Every business concern keeps books, but if the manager cannot read them, he cannot make them useful tools in the conduct of his business. How to read the accounting books is in fact the subject of the present Reading Assignment. It clears up much that seems abstruse and difficult. The reader is surprised to find how the figures glow with life and he gains a clearer insight into the direct aid which financial statements can give in formulating executive decisions.

Basing Decisions on the Facts

> The business man must base his action regarding his future business policies upon the experience of past performances as shown by properly classified records. He must not rely on memory.—Page 3, Chapter I, Volume 22 of the MODERN BUSINESS Text.

Rear Admiral Samuel MacGowan, as Paymaster General of the Navy, held a position which carried great responsibilities. With the handling of all payments, great and small, for the navy, his was one of the biggest business positions of the country. The visitor to Admiral MacGowan's office found in it one chair and a desk. The desk was like a man-of-war cleared for action, nothing to be seen upon it but the necessary writing materials. In the one chair before the desk sat the admiral. The visitor was not expected to linger. He stood as he stated his business, heard what the admiral had to say, and departed. All day long there was a stream of people pouring into the office, and all day long the admiral kept up his series of rapid-fire decisions.

Making decisions is the chief business of an executive. Some men can never be executives because of constitutional indecision. They are timid, vacillating, mistrustful of themselves. They are as useless in executive positions as the blustering dunderhead is harmful. The man who does not know how to de-

cide, yet will decide, is as much of a nuisance in business as the lady who cannot sing, but will sing, is an affliction in the social circle.

The inexperienced novice who owes his place in the business to his father's money and is ready offhand to decide important matters of business policy, is only the caricature of an executive. For the latter bases his decisions upon the facts, which are assembled for his consideration either thru the regular processes of his administrative machinery, or as the result of a special inquiry into the question at issue. He does not work at haphazard and his training has taught him to know what facts are pertinent and to appraise them judiciously.

Developing Executive Ability

Progressive business men are at the present time much concerned in the effort to develop executive ability among their department heads, and those to whom they are forced to intrust responsibility. The Bramwell Manufacturing Company is one of these progressive concerns.

Its president and general manager has come up thru the accounting departments, and is proud of it. He frequently speaks of the time when, as a junior clerk, he was posting entries at $10 per week. He is an accountant in the true sense of the word, for he has a broad and masterly understanding of the value of proper records as a basis for the successful conduct of a business. "You can't decide unless you have the facts," is a favorite expression of his. And

for his "facts" he wants records—intelligently kept, detailed records of past performance, comparative statements by months and years, properly analyzed as to causes of differences and as to future prospects. This is a theme upon which he delights to dwell when he gathers about him his officers and department heads at a monthly dinner for good fellowship and the discussion of company affairs.

Three Essentials

"Each one of us here to-night," he said at one of these monthly dinners, "is charged with the management of some part of the Bramwell Company's business. We shall be successful in our work just in proportion as we bring to it, first, an understanding of what is expected of us; second, a clear idea of what we may hope to accomplish; and third, an exact knowledge of past happenings. The last of these is especially important. How can we know, for example, whether our departments are being successfully—that is, efficiently and economically—operated unless we have complete records of the work done in them? How can you gauge truly the ability and value of the persons in your departments unless your records show the quality and quantity of their work during a measured period?

Records That Help

"The information which you will find most helpful to you may be divided into two classes:

"1. The regular monthly accounting statements

which are prepared by our accounting department, and copies of which are sent to each one of you who is connected with the control of one or more of the divisions of the business which are recognized in the accounting records.

"2. Supplementary statistical and graphical statements which go more into detail than do the financial statements, and which are intended to supplement and to explain the regular monthly statements themselves.

"You should understand clearly, in the first instance, what the regular financial statements can do for you. They are summaries which show net results and disclose tendencies. In a sense they are controlling elements in executive management, because upon them you should depend in measuring the success of your work. Each of us contributes in some measure to the results of the business, and what we have done shows first in each single department statement, and then in the general consolidated statement for the business as a whole. Each should therefore examine carefully and study in all its bearings the statement which concerns his own department.

"The statistical statements are far more varied in their nature, and are often founded upon special rather than general records. Nor are they at all uniform in the various departments, or in various forms of organization, for that matter. Each statistical statement should be devised for a special purpose, and should not be used unless it clearly serves the purpose for which it is intended.

"Graphs also have their place, chiefly because they offer a quick means of grasping rapidly the results of business management. Some men will tell you that graphs can take the place of all other forms of records, but to my mind this is not true. They are limited in that they can show tendencies only, and cannot accurately measure or portray results. They do not lead to definite action as well as do figures when one has the ability to interpret these figures. They are at best a means of obtaining impressions. Any action should be based upon the figures from which the graphs are drawn rather than upon the graphs themselves.

Using Statistics

"Some years ago, while I was assistant to the then president, we had a department in the shop which was supposed to be very valuable. There was a fine technical man in charge, and half a dozen good mechanics at work in it. The men used to call it the 'high-brow' department. I felt right along that this department wasn't earning its salt, and I mentioned it once or twice to the president, but he thought otherwise. Finally I prepared and laid before him a detailed record system for that department and asked his consent to have it installed. He gave it, and about two months later that department was abandoned by his own order as an unprofitable investment. The figures convinced him.

"Another thing in this connection. You are not doing justice to the good workers in your department

unless your records give them full credit for what they do. You owe it to them to keep such records, so that merit in all cases may be properly rewarded. And let me say, good men are always scarce enough. Don't let us cover them under a blanket of mediocrity for lack of proper records.

Determining New Policies

"Even more important, if possible, is the matter of determining new policies upon the basis of past performance. It is easy to rectify a mistake in policy before it becomes serious, if we know just what is being accomplished. But without proper records we might go on perpetuating an error that would become exceedingly expensive in a short time."

"Perhaps you have in mind the big boring machine that we all believed to be a big earner until records convinced us that it was the opposite?" interrupted the factory superintendent.

"That is a case in point," the president rejoined. "Our first impression, as I remember, was based upon the records of thirty days, during which the machine was being used almost constantly; but when we got the records of six consecutive months, we saw that it didn't pay interest on the investment. The early records were correct enough, but they were inadequate."

Williams' Auto

"It seems to me," remarked the sales manager, "that the point made here tonight is pretty well

illustrated in the case of one of our salesmen—Williams—who covers part of Ohio and western Pennsylvania. That chap had been urging us to get him a motor car so that he could get over the ground more rapidly and so that he could call on dealers in the smaller places where few trains ever stopped. Well, we didn't take kindly to the idea; we had a feeling that Williams wanted to combine pleasure with business; very pleasant for Williams, perhaps, but hardly profitable for the company. So we threw cold water on his project. But one day Williams walked into my office with a few sheets of paper that said more in a few minutes than Williams had said in many months.

"They gave a statement of his travel for a period of two months. They showed the number of miles actually traveled, the number of idle hours when waiting for transportation, the cost of his trip figured per mile of travel, the number of stores visited, the volume of orders taken, and so on. Then they showed the number of miles per day that could be reasonably covered in a motor car; the towns off the railroad that could be visited; the number of stores in those towns, and an estimate of the added volume of sales that could be made in the same period of time as that in which he had formerly made his circuit. Finally, the sheet showed the cost of a suitable car, the probable cost of operation and repair, and when the outlay was balanced against the prospective gain, I quickly saw that we had probably been losing several thousand dollars a year by our old method of covering

that territory. You remember the case, Mr. President, and I remember the remark you made when I laid Williams' figures before you. You said: 'It looks as tho we could afford to give him two cars, if he could use them.' Of course Williams got his car, and we have got enough new business to yield us fifty per cent on our investment."

Some general discussion followed the sales manager's narrative; several of the men recalled cases in their own departments where adequate records had effected a saving, stopped a leak or demonstrated the wisdom of a new plan.

Decisions, Wise or Otherwise

Then the president spoke again: "I want to say a word about making decisions. You and I have to make decisions every day. We don't always make wise decisions, tho I am sure we all try to do so. When we have made wrong decisions, hasn't it often been because of insufficient data? Yet in most cases the information was obtainable. In other words, we could have decided properly if we had made provision in advance for the contingency that arose. You and I want our decisions to be wise decisions, not such as are formed by the tossing of a coin. And as nearly all our decisions relate to the management of our own departments, you can see the wisdom of using the greatest care that every bit of information pertaining to our special work and to the members of our departments be so kept and arranged that it

will be instantly available when wanted. We don't want to be coin-tossers!

"Years ago I knew a man who operated a machine shop in a southwestern city. He was a man of decision. He undertook on one occasion, on the spur of the moment, to build a brick press, and had his draftsmen prepare drawings and specifications from his own sketches. Castings were made and the machine work was well under way when he decided to change the position of the cam and to widen the bed. Well it meant practically starting all over again. This sort of thing happened repeatedly, and it took him the better part of a year before he got his brick machine assembled and ready for a test. Then it was found that the pressure was insufficient and that the thing would not do at all, and he had to scrap the labor of a year. Now the point is that brick-making machines have been in use for many years, hence data are obtainable from which this man could have learned all he needed to know, both about the requirements of such a machine and the various ways in which these requirements had been met in the past. But no, he could not wait to collect the facts; he wanted himself regarded as a man of action; he succeeded in getting himself regarded as a fool. Eventually he lost his business. He had been relying upon his judgment unaided by records and data, and he had lost out, as every one must under similar conditions."

"He deserved what he got, it seems to me," came from one of the junior department heads.

"Yes," rejoined the president, "we usually get what we deserve in this world, anarchists and others to the contrary notwithstanding."

Business Statements

A river system consists of the main stream and numerous tributaries. Oftentimes the flow of water in each is carefully watched and recorded by government agents. While conditions in the tributaries are important, the chief interest attaches to the main stream. In business the tributaries are the different departments, and we have seen how their activities must be carefully watched if they are to play their proper part in contributing to the main stream of the business itself.

In the accounts of the business as a whole the manager finds the summarized statement of the varied activities of the business. The major accounting records are the income statement and the balance sheet. Needless to say that they should be prepared in accordance with accurate accounting principles, and when prepared should be studied with intelligence in order to determine policies for the business as a whole.

The Test of Executive Judgment

It is here that the judgment of the executive is put to the finest test. Because these statements are general in form, the tendencies which they reveal are often hidden except to the most far-seeing eye. The composite of forces of which the business is made up

are here reduced to simple expressions which may illuminate the experienced man of business, but are often meaningless to those of lesser insight. Each figure given is challenged by the thoughtful executive. He requires that its meaning be made clear by comparison with former results, and if this fails to enlighten him, he directs his attention to the subsidiary records on which they are founded. So far as these fundamental records go, the only proper attitude for the executive is that of a human question mark. If as a result of this persistent questioning he thoroly understands precisely what each item in the accounts means, he has the basis upon which to plan the future of his business.

Knowing What You've Got

How important accurate accounts and an intelligent interpretation of them are can be seen in considering the proper valuation of assets in financial statements. Such valuation is often concealed from the eyes of the management thru a faulty classification of the assets. That was the case with the Climax Publishing Company which a few years ago nearly put itself out of business thru its method of classifying assets. The company awoke to its danger only when a certified public accountant was called in to audit the items in a financial statement prepared at the request of the bank. There was a large subscription list, considerable money in the bank and a generally flourishing condition. Imagine the surprise of the management when the auditor announced that

its affairs were in a precarious condition and its credit greatly over-extended.

When asked to explain, the auditor pointed to the recently prepared balance sheet. Among the assets listed was the following item: Book and Art Plates, $563,807.50.

"Here is more than half a million dollars," he commented, "tied up in an asset that is of almost no value. At least 80 per cent of this amount should have been gradually charged off as expense; instead, you are carrying the whole amount as an asset. Do you know that in the last six months you have sold only 1,250 books made from these plates and that your total receipts from these sales are less than $1,700?"

The managing director objected that a large part of this account consisted of high-class color plates, some of which cost as much as $500 for a single set, and that a considerable number of prints from these plates were being sold right along.

"True enough; and in these color plates lies almost all the value that can rightly be ascribed to the account 'Book and Art Plates.' Yet you don't seem to realize that the very excellence of your magazine prints reduces the value of these plates, since the average person would just as soon cut the print from the magazine as buy one specially printed. For framing, one is about as good as the other. This is indicated by the fact that your sales of prints during the last six months is less than $4,000.

"Now look! You are getting an income of less

than $5,700 from assets which you carry on your books at $563,807.50. That means you are earning about one per cent on an investment which represents one-half of your surplus. Does it pay?"

When Assets Are Liabilities

As the astonished director had to admit the justice of this criticism, the auditor went on:

"But that is not all, nor is it the worst. Your present subscription list is not even an asset—it is a liability."

"*What,* a liability?"

"Yes, sir, a liability. Look, if you please, at this income statement. Here you have included as earnings the entire amount of subscriptions received. Yet many of these subscriptions are for periods of two to three years. I have endeavored to ascertain the average unexpired term of your subscriptions. I had my assistants choose at random 1,000 names and average the terms. They found that at the present time you owe these 1,000 subscribers seven and one-eighth future numbers for which you will receive not another penny. If this is typical of the whole list, it is plain that it is not an asset but a liability. Consider, furthermore, that a large percentage of your subscriptions were secured by the use of premiums. You cannot count on renewals in their case. That makes your situation all the worse.

"If you wish to know exactly where you stand, simply compute the cost of publishing seven and one-eighth issues, and deduct from this amount the

net income from advertisements—a rapidly diminishing amount, by the way. That will measure pretty accurately your liability."

The Climax Publishing Company is still in business, thanks to a complete reversal of its financial policy. The management, after much hard work, is slowly getting the magazine back upon its original basis where profits, tho smaller, are sure, and where all assets are real assets.

"I think," said the managing director not long ago, "that after the experience I have passed thru I shall be able hereafter to recognize a liability when I see it."

The Able Executive

At the outset of this Talk it was said that an executive was one who made decisions. But we have seen that there must be a basis for executive decisions and this might have been the title of the Talk. That basis is found in facts properly recorded and correctly interpreted. It is on this basis that the wise executive founds successful business policies.

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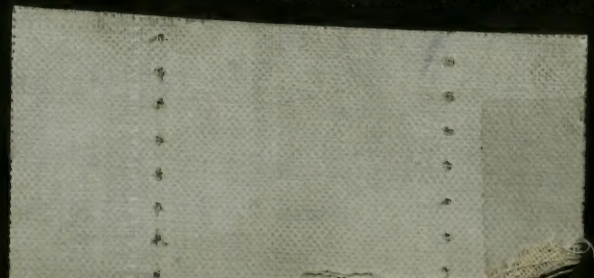

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